**DEPARTMENT OF STATE REVENUE**
**SUPPLEMENTAL LETTER OF FINDINGS: 02-0030**
**Indiana Corporate Income Tax**
**For the Years 1995, 1996, and 1997**

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## ISSUES

**I.** **Money Received From the Sale of Computers and Related Services to Indiana Remarketers** – Gross Income Tax.

**Authority**: IC 6-2.1-2-2(a)(2); IC 6-2.1-3-3; IC 6-8.1-5-1(b); 45 IAC 1.1-2-5(a); 45 IAC 1.1-2-5(d); 45 IAC 1.1-3-3(c); 45 IAC 1.1-3-3(c)(5).

Taxpayer argued that the money it receives from selling computers and computer-related services to Indiana remarketers is not subject to gross income tax.

**II.** **Investment Income** – Adjusted Gross Income Tax.

**Authority**: IC 6-3-1-20; IC 6-3-1-21; IC 6-3-2-2(b); IC 6-3-2-2(g) to (k); May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30.

Taxpayer maintains that money it earns from investing excess funds in an "investment portfolio" is entirely "non-business income" for purposes of determining taxpayer's adjusted gross income.

## STATEMENT OF FACTS

Taxpayer manufactures and sells computers and computer software. Taxpayer has business locations and personnel within and outside the Indiana. During 1995, 1996, and 1997, Taxpayer filed consolidated tax returns. During 2001, the Department conducted an audit review of Taxpayer's tax returns and business records. The audit review resulted in the assessment of additional corporate income taxes. Taxpayer disagreed with some conclusions contained within the audit report—and submitted a protest. An administrative hearing was conducted during which Taxpayer explained the basis for its report. A Letter of Findings was written based on the information presented at the hearing, the supplemental information Taxpayer supplied, and the information contained within the original audit report. Taxpayer sought and was granted a rehearing to reconsider the disposition. This Supplemental Letter of Findings results.

## DISCUSSION

**I. Money Received From the Sale of Computers and Related Services to Remarketers** – Gross Income Tax.

Taxpayer sells its computers, software, and related services using a variety of methods including sales to two out-of-state remarketers. Remarketer One is headquartered in California; Remarketer Two is headquartered in Florida.

According to Taxpayer, the sales to Remarketer One were arranged in California and the equipment shipped from the point of manufacturer to Remarketer One's warehouse in Indianapolis. According to Taxpayer, the sales to Remarketer Two occurred in Florida and the computers shipped to Remarketer Two's distribution center in South Bend. According to Taxpayer—Taxpayer's in-state personnel were not involved in the sale of the computers, services, or associated software; the in-state personnel were not involved in the initiation, negotiation, or servicing of the either of these sales contracts.

The audit review assessed gross income tax on the money taxpayer received from Remarketer One and from Remarketer Two at the "low" and "high" rates—differentiating between the money taxpayer received for the sales of the computers and the money received for the provision of services related to those computers.

Gross income tax is imposed upon the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana. IC 6-2.1-2-2(a)(2). However, gross income derived from business conducted in commerce between Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution. IC 6-2.1-3-3.

Taxpayer argues that the money received from the sale of computers and services to the two remarketers is not subject to gross income tax because the underlying sales transactions were unrelated to the taxpayer's Indiana sales personnel and Indiana sales locations. 45 IAC 1.1-3-3(c) states that "Gross income derived from the sale of tangible personal property in interstate commerce is not subject to the gross income tax if the sale is not completed in Indiana." The regulation provides an example relevant to the specific issue raised by taxpayer.

> A sale to an Indiana buyer by a nonresident with an in-state business situs or activities but the situs or activities are not significantly associated with the sale because [the sale] was initiated, negotiated, and serviced by out-of-state personnel, and the goods are shipped from out-of-state. The in-state business situs or activities will be considered significantly associated with the sale if the sale is initiated, negotiated, or serviced by in-state personnel.

45 IAC 1.1-3-3(c)(5). To establish that the sales of computers to the two remarketers were not associated with Taxpayer's Indiana sales location and Indiana sales personnel, Taxpayer provided eight current affidavits from key personnel located within and outside Indiana. These affidavits stated what business transactions were conducted where and by whom. The effect of

the affidavits is to establish that Indiana merely is a warehousing and distribution outlet for the computers. Supplementing the affidavits are copies of the contracts between the Taxpayer and the remarketers. At the hearing, Taxpayer brought in their Indiana General Manager to testify that he and his personnel have no dealings with the remarketers. Taxpayer's tax attorney appeared at the hearing via telephone and provided additional testimony related to how the business divisions are structured, the functions of the business divisions, and the fact that Indiana sales and service personnel have no relationship with the remarketers . The testimony, documentation, and evidence presented are convincing to rebut the presumption of the audit concerning the sale of these computers to the remarketers.

Taxpayer also argues that the revenue received from Remarketer One and Remarketer Two—derived from the provision of computer services—is not subject to gross income tax because the services were related to the underlying interstate sales of computers. 45 IAC 1.1-2-5(a) states, "Gross income derived from the provision of a service of any character within Indiana is subject to the gross income tax. This is true even when a service contract calls for the furnishing of tangible personal property in the performance of the contract." The same regulation further states that, "Gross income derived from the provision of a service within Indiana . . . on goods belonging to another is subject to gross income tax even though such property is moved in interstate commerce before or after the performance of the service." 45 IAC 1.1-2-5(d).

Revenues received for services are subject to gross income tax. Taxpayer pre-loaded software onto the computers it sold to the remarketers. This pre-loading of software, done outside of Indiana, is the provision of tangible personal property. This software is placed into the computer during the manufacturing process to prepare the computer for sale. Taxpayer purchased the rights to third-party software packages—and is required to pay the third-parties for the software. These royalty amounts were separated out in the accounting breakdown of revenues. Taxpayer is providing tangible personal property; as such it is part of the intrinsic computer purchase. Since the computer itself is not subject to the gross income tax—for the reasons named above—neither is the included pre-loaded software—because it is not a service—but the sale of tangible personal property.

However, Taxpayer earned revenues for services it provided to Remarketers One and Two. Taxpayer provided the remarketers support documentation, advertising, and promotional materials. Taxpayer retained sales, warranty, and service records on behalf of the remarketers. Taxpayer conducted technical seminars and provided technical services for the remarketers. Despite the fact that the sales to the remarketers were conducted in interstate commerce, these support services were conducted in Indiana. In consideration, the remarketers compensated taxpayer. That compensation is subject to the gross income tax. Taxpayer did not present sufficient evidence to rebut the statutory presumption of IC 6-8.1-5-1(b).

## FINDING

Taxpayer's protest is sustained—with the exception of the revenue for the services. Taxpayer is sustained on the sales of the computers and revenue from income allocated as royalty payments. Taxpayer is denied on the income it received from services provided to the remarketers.

**II. Investment Income** – Adjusted Gross Income Tax.

The discussion below is the same as was stated in the original Letter of Findings. Taxpayer conceded the issue at the rehearing. It is included in this Letter of Finding so as to provide a unified disposition of this case.

The audit review found that money taxpayer earned in the form of "short term interest" constituted "business income." Taxpayer disagrees concluding that what it calls "Portfolio income" arose from transactions outside taxpayer's regular business activities and that the money should be classified as "non-business income." Taxpayer maintains that the acquisition of the securities "did not arise out of or were not created in the regular course of [taxpayer's] trade or business operations and the purpose for acquiring the holding the securities was not related to or incidental to such trade or business operations." As a result, taxpayer maintains that the portfolio/security income should be allocated to the state in which taxpayer's headquarters is found.

Taxpayer states that it maintains a "substantial investment portfolio composed of various types of interest-bearing and discount securities and money-market investments." The investment portfolio was devised as a means of safely and profitably investing surplus cash with the goal of obtaining the most attractive return possible; taxpayer states that investment decisions are based strictly on prevailing "economic and market conditions" and are unrelated to the needs of taxpayer's "regular trade or business." According to taxpayer, it maintains an investment department at its out-of-state headquarters and that all activities related to the management of the investment portfolio originate within this department. In order to manage its investment portfolio, taxpayer maintains a staff of personnel who have no duties or responsibilities within taxpayer's core business operation. Taxpayer describes that core business as the "development, manufacture, rental, sale and service of technical, commercial and scientific products, mainly data processing . . . and office equipment and a wide range of support and systems management services." In sum, taxpayer maintains a department and personnel, distinct from its core computer business, dedicated to investing taxpayer's surplus cash.

For purposes of determining a taxpayer's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three factor formula. IC 6-3-2-2(b). In contrast, non-business income is allocated to Indiana or it is allocated to another state. IC 6-3-2-2(g) to (k). Therefore, "whether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

Taxpayer's argument, that this income constitutes "non-business income," is significant because if taxpayer is correct, all this income is allocated elsewhere and is not relevant in calculating taxpayer's Indiana adjusted gross income tax.

The benchmark for determining whether income can be apportioned is the distinction between "business income" and "non-business income." That distinction is defined by the Indiana Code as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operation.
> IC 6-3-1-20.

"Non-business income," in turn, "means all income other than business income." IC 6-3-1-21. For purposes of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while non-business income is allocated to Indiana or another state in which the taxpayer is doing business. May, 749 N.E.2d at 656. In that decision, the Tax Court determined that IC 6-3-1-20 incorporates two tests for determining whether the income is business or non-business: a transactional test and a functional test. Id. at 662-63. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. The particular transaction from which the income derives is measured against the frequency and regularity of similar transactions and practices of the taxpayer's business. Id. at 658-59.

Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. *See* IC 6-3-1-20.

Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in relevant part that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business income therefrom depending upon but not limited to some or all of the following:

(1) The nature of the taxpayer's trade or business.
(2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income for a given tax period.
(3) The frequency, number of continuity of the activities and transactions involved.
(4) The length of time the property producing income was owned by the taxpayer.
(5) The taxpayer's purpose in acquiring and holding the property producing income.

The functional test focuses on the property being disposed of by the taxpayer. Id. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. May, 749 N.E.2d at 664. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. In May, the Tax Court

defined “integral” as “part of or [a] constituent component necessary or integral to complete the whole.” Id. at 664-65. The court concluded that petitioner retailer’s sale of one of its retailing divisions was not “necessary or essential” to the petitioner’s regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not the petitioner. Id. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner’s own business operations. Id. Therefore, the proceeds from the division’s sale were not business income under the functional test. Id.

The audit correctly concluded that the money received from the portfolio investments was “business income.” The information offered by taxpayer itself demonstrates that it regularly engages in the sale and purchase of securities in order to maximize the value of its surplus cash assets. The sales and purchase of securities is such an ordinary part of taxpayer’s business that it maintains a separate business division and hires personnel specifically dedicated for that purpose. The investment proceeds are properly classified as “business income” pursuant to the transactional test.

In addition, the income is properly classified as business income under the functional test because the sale and purchase of securities constitutes an integral part of the taxpayer’s business. Therefore, the income meets the “functional test.” Although taxpayer may be correct in stating that it is in the computer business and not the investment business, that distinction is irrelevant. The issue is not whether or not taxpayer is in the investment business, the issue is whether the investment income is “business” or “non-business” income. In this instance, there is nothing extraordinary taxpayer’s investment of excess cash in order to maximize the value of that cash. To the contrary, the practice appears to be a day-to-day part of taxpayer’s overall business; the investment income is neither unusual nor unexpected and falls squarely within the definition of “business income.”

## FINDING

Taxpayer’s protest is respectfully denied.

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